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A Case Study on a Liquidity Crisis

A very real challenge we face is a lack of liquidity in both the bond and stock market for smaller investments. We see three reasons for this liquidity crisis; two are global issues and one is unique to Canada.

The first issue is the increased capital and the quality of the capital held by global banks as a safety cushion against bad loans, as well as restriction on their ability to speculatively trade with this capital. Anecdotally, global banks have had to increase capital by $2 trillion dollars to protect against the potential of future bad loans. As a result, banks have to hold these new assets of $2 trillion, not trade them, which takes $2 trillion out of the market thus reducing liquidity. Keep in mind that the entire Canadian economy is worth about $2 trillion dollars and $2 trillion dollars is also the size of the entire Canadian stock market.

The second issue is the near universal acceptance of index investing. There are many good reasons why indexing is popular but the result is that most investment money is concentrated in the main broad market indexes and these by definition invest mainly in the biggest companies. Also, high frequency trading is on the rise and this type of trading concentrates only on big and active securities. What we are finding is that there is almost no trading volume in any security that is below $1 billion in market value.

Finally**,** we have the home grown development called CRM2 which is an acronym for Client Relationship Model Phase 2. CRM2 are amendments to the regulations for all Canadian stock brokers imposed by the Canadian Securities Administrator (CSA). By this coming July every stock broker in Canada will have to report performance and fees to their clients. This is what Avenue has always done but stock brokers have never been held to account before. The result is that the market in smaller and creative investments has all but dried up as brokers seek to retain the trust of their clients. In other words, there is no appetite for risk. As an aside, the measurement the CSA picked to report performance is faulty and in reality not all fees are going to be disclosed. This topic might be better addressed in a future case study.

So in 2015 we have done our best to retain our wealth in this liquidity vacuum. But now that we have lived through what we hope is the majority of the downward move in stock prices, we find ourselves in a position with favourable risk reward. Three of our investments, BTB Reit, Timbercreek Mortgage Investment and Sirius XM, all have consistent income streams and now yield over 9.5%. Because of this liquidity problem in the stock market, we believe these investments are being given away and that is good for us.

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